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REPORT TO BUDGET AND FINANCE COMMITTEE

OPPORTUNITIES AND LIMITATIONS ON THE CITY'S ABILITY TO TRANSFER
WATER AND SEWER UTILITIES

INTRODUCTION

At the Budget Committee meeting on November 10, 2010, the question was raised whether the City could transfer enterprise fund activities. This report addresses opportunities and limitations on the City's ability to transfer the City's water and sewer utilities.

DISCUSSION

I. PUBLIC-PRIVATE PARTNERSHIPS

The California Government Code allows cities and local agencies to enter into public-private partnerships to provide private financing of public infrastructure.

It is the intent of the Legislature that this chapter be construed as creating a new and independent authority for local governmental agencies to utilize private sector investment capital to study, plan, design, construct, develop, finance, maintain, rebuild, improve, repair, or operate, or any combination thereof, fee-producing infrastructure facilities This chapter may be used by local governmental entities when they deem it appropriate in the exercise of their discretion.

Cal. Gov't Code § 5956.2

The legislation allows a governmental agency to solicit proposals and enter into agreements with private entities for the design, construction, reconstruction, or lease to private entities for fee-producing infrastructure projects such as irrigation, water supply, treatment, and distribution, flood control, municipal improvements, sewage treatment, disposal, and water recycling. Cal. Gov't Code § 5956.4.

This legislation allows certain water and sewer utility assets to be temporarily transferred to a private entity if they need private financing for improvements. Infrastructure constructed for the City by a private entity can be leased or owned by the private entity for a maximum of 35 years, after which the facility must revert to the agency. Cal. Gov't Code § 5956.6. This legislation does not address the transfer of an entire water or sewer utility not otherwise in need of private capital,¹ but it does offer some opportunity to partner with the private sector.

II. RESTRICTIONS IMPOSED BY BOND COVENANTS

The City's ability to pursue public-private partnerships or other transfers is substantially limited by the City's water and sewer bond covenants. The bond covenants are promises the City made as a condition of receiving bond financing of certain water and sewer infrastructure improvements. The City's bond covenants are the terms of Master Installment Purchase Agreements (MIPAs) for the water and sewer utilities. The water bond covenants prohibit the City from selling, leasing, or disposing of the water system except under certain conditions:

Section 6.04 Against Sale or Other Disposition of Property.

(a) The City will not sell, lease or otherwise dispose of the Water System or any part thereof essential to the proper operation of the Water System or to the maintenance of the System Revenues, except as provided in Sections 6.04(b) and Section 6.19 hereof. Further, the City will not, except as otherwise provided herein, enter into any agreement or lease which impairs the operation of the Water System or any part thereof necessary to secure adequate Net System Revenues for the payment of the Parity Obligations or which otherwise impair the rights of the Corporation with respect to the System Revenues or the operation of the Water System.

(b) The City may dispose of any of the works, plant properties, facilities or other parts of the Water system, or any real or personal property comprising a part of the Water System, only upon the approval of the City Council and consistent with one or more of the following:

(1) the City in its discretion may carry out such a disposition if the facilities or property being disposed of are not material to the operation of the Water System, or shall have become unserviceable, inadequate, obsolete or unfit to be used in the operation of the Water System or are no longer necessary, material or useful to the operation of the Water System, and if such disposition will not materially reduce the Net System Revenues and if the proceeds of such disposition are deposited in the Water Utility Fund;

¹ With regard to the water utility, the City Charter contemplates at least some level of involvement that is permanent. San Diego Charter § 53 ["There shall be included in the administrative organization of the City a separate utility to be known as the Water Utility."]

(2) the City in its discretion may carry out such a disposition if the City receives from the acquiring party an amount equal to the fair market value of the portion of the Water System disposed of. As used in this clause (2), "fair market value" means the most probable price that the portion being disposed of should bring in a competitive and open market under all conditions requisite to a fair sale, the willing buyer and willing seller each acting prudently and knowledgeably, and assuming that the price is not affected by coercion or undue stimulus.

This bond covenant prohibits the City from selling water utility assets unless they are no longer needed to provide water service and provided the water utility receives fair market value. The sewer bond covenants contain a substantially similar restriction, with one notable exception described in Section III below.

While preventing the sale of necessary water utility assets, the water bond covenants allow another entity to operate part or all of the water system.

Section 6.19 Subcontracting. Nothing herein to the contrary shall prevent the City from delegating the power to be an operator of some or all of the Water System, even though the City continues to retain ownership of the Water System and its operations, and no such subcontracting arrangement shall relieve the City of any of its obligations hereunder. Prior to the effective date of any such delegation, the City shall deliver to the Trustee an opinion of Bond Counsel to the effect that the proposed delegation will not have an adverse effect on the exclusion from gross income for federal income tax purposes of the interest component of Tax-Exempt Installment Payment Obligations.

The City must maintain ownership of the water utility, but it may hire an outside operator.

III. THE SAN DIEGO AREA WASTEWATER MANAGEMENT DISTRICT

The sewer bond covenants specifically allow the transfer of ownership of the Metropolitan Sewerage System (Metro System) to another public agency:

Section 6.20 Transfer of Metropolitan System Components. Notwithstanding anything to the contrary herein contained, the City may transfer ownership of substantially all of the Metropolitan System, including amounts in the Sewer Revenue Fund attributable to the Metropolitan System, and any amounts in the Rate Stabilization Fund agreed upon by the City and the transferee as being attributable to the Metropolitan System, to the District or any other governmental agency whose primary purpose is to provide wastewater treatment and disposal service

The Metro System consists of the Point Loma Wastewater Treatment Plant, the North City and South Bay Water Reclamation Plants, the Metropolitan Biosolids Center, Sewer Pump Stations 1 and 2, the North and South Metro Interceptor Sewers, and most other major sewer infrastructure that interconnect or tie into these facilities. The remainder of the sewer utility is commonly known as the Municipal Sewer System, consisting of about 3,000 miles of sewer mains and trunk sewers, and dozens of smaller sewer pump stations.

This sewer bond covenant was drafted specifically to recognize the San Diego Area Wastewater Management District (District). The District was created by state legislation in 1992. Cal. Stats. 1992, ch. 803 (S.B. 1225). The purpose of the District is to provide increased decision-making authority to the public agencies that rely on the Metro System for sewage treatment and disposal. Cal. Stats. 1992, ch. 803 § 101(f). The impetus for the District came primarily from the other public agencies:

With regard to municipal involvement in the formation of the district, the City of San Diego, as the current sole owner of the wastewater system, has been instrumental in the proposed creation of the district. However, the impetus for the district's formation, came from other public entities whose representatives appeared before the San Diego City Council demanding that the City establish a means by which they could meaningfully participate in wastewater system decision-making functions.

City Att'y MOL No. 92-13 (Feb. 14, 1992).

The City Council endorsed the creation of the District. San Diego Resolution R-279615 (Mar. 24, 1992). The City anticipated that some City employees working for the sewer utility would become employees of the District. *See* City Att'y MOL No. 91-55 (Aug. 6, 1991).

While still in its infancy, the District's effectiveness was severely compromised by disagreements between the City and other member agencies. The City was concerned that the District's weighted voting structure ceded too much authority to the other member agencies. *See* City Att'y Report 93-22 (Apr. 16, 1993); *see also* City Att'y Report 93-33 (July 2, 1993). There were also disputes over allocation of costs and transfer of assets to the District. *See* City Mgr. Report No. 94-163 (June 6, 1994). Chula Vista, La Mesa, and the County of San Diego withdrew from the District. El Cajon declined to join the District. The City of San Diego withdrew from the District as well, as authorized by the City Council. San Diego Resolution R-284356 (July 26, 1994).

The District still exists, but meets only once annually to appoint officers and approve ministerial matters. It is still a viable entity and could be resurrected if the City and the other member agencies can agree to terms. Any proposal that may affect City employees should be reviewed to ensure the City's compliance with legal obligations to its employees under the San Diego Charter, relevant San Diego Municipal Code provisions, personnel rules and regulations, and state law, including the Meyers-Milias-Brown Act.

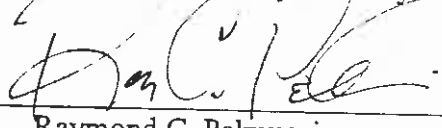
The City currently engages the other agencies through the Metro Commission, a purely advisory body created in 1998 by the Regional Wastewater Disposal Agreement which governs the use of the Metro System by the participating agencies. These participating agencies have also formed the Metro Wastewater Joint Powers Authority (JPA) to engage the City on issues related to the Metro System. The City is not a member of the Metro Wastewater JPA, but its meetings are held concurrently with meetings of the Metro Commission.

CONCLUSION

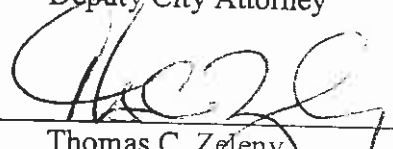
While there may be some opportunity to transfer water or sewer utility assets under state law, the City's ability to make such a transfer is substantially limited by the water and sewer bond covenants. The water utility can only transfer assets that are no longer needed to provide water service, though the City may hire a private entity to operate the water system. The sewer utility is similarly restricted, but it may transfer the Metro System to the District or another public agency whose primary purpose is to provide sewer service. If transferring utility assets or rejoining the District affects City employees, the City will need to address the associated labor issues.

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